

To:

Mr. Troy Butzlaff, City Administrator

From:

Cathy Standiford, Partner

Subject:

Budget Stabilization Plan - Summary of Observations and Recommendations

Date:

December 18, 2013

This memorandum summarizes the options and alternatives available to the City of Placentia to address an ongoing structural imbalance between revenues and expenditures. A multi-year financial forecast prepared by Management Partners earlier this year projected a \$1.5 million deficit for FY 2013-14 and annual deficits each year for the next four years. Management Partners was asked to conduct additional analysis to identify options and alternatives for Placentia to achieve budget stabilization. This memorandum provides several observations about the City's current financial and organizational condition. Following these observations we present options to achieve budget stabilization and their financial impacts in three categories: 1) revenue enhancements, 2) compensation changes, and 3) alternative service delivery.

In summary, the difficult financial condition Placentia faces that caused Management Partners to be retained to conduct this analysis is more challenging than first understood. Indeed, if the City does not make what will surely be very difficult policy decisions and take action to bring revenues and expenditures into balance at the earliest possible opportunity, the consequences could be extremely serious.

### Financial and Organizational Observations

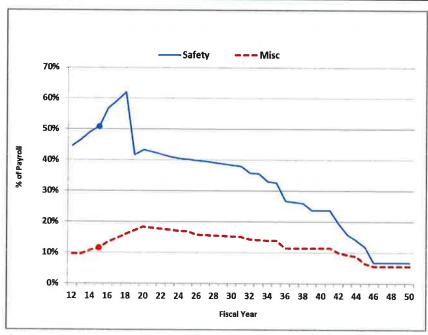
- Placentia's overall financial condition has not changed since we provided a multi-year forecast to the City Council in May 2013. Placentia is projected to experience significant deficits for the next five years under any reasonable scenario. Our earlier projections did not include the impacts of recently approved rate increases by the California Public Employees Retirement System (CalPERS), the Affordable Health Care Act, or funding for other City needs that may emerge.
- 2. The Placentia organization is showing signs of significant organizational stress and fatigue. Symptoms of organizational stress identified through interviews and focus groups include low morale, low trust in the City's elected and appointed leadership, high anxiety over the City's future financial uncertainty, reduced collaboration and communication between departments, and an "us versus them" attitude between employees and the City's

leadership and between Police Department employees and the rest of the organization. Employees express pride in the quality of services being provided and the creative solutions that have been found thus far to reduce costs. However, they lack confidence in the financial information they have been provided and desire a more balanced approach to resolving the City's financial challenges by considering revenue increases.

3. A multi-year forecast of Placentia's retirement rates and associated costs indicates that rates for both safety and miscellaneous plans will increase substantially over the next seven to eight years. Rates will peak at a high of 62% of payroll for safety members and 18% of payroll for miscellaneous employees. Currently the employer rate for Placentia's safety plan is 49.161% while the rate for the miscellaneous plan is 10.781%. Management Partners has developed a model to forecast employer retirement costs over a 40-year period. The model takes into account recent rate smoothing, amortization and mortality improvement adjustments approved by the CalPERS Board of Directors, and the impact of the Public Employees' Pension Reform Act (PEPRA), as well as an additional 0.25% reduction in the PERS discount rate, which has been discussed but not yet approved by the Board.

We used the City's current payroll data and the June 30, 2012 valuation reports from CalPERS to generate a forecast for future employer retirement rates. The results of the forecast are presented in Figure 1, which shows significant increases for both plans over the next seven years. Rates for safety retirement will drop by 20% in FY 2018-19 when a side fund agreement with CalPERS to reduce unfunded liability is paid in full. Rates will further decline over time as more employees become covered under the new Tier 2 benefit plan.

Figure 1. PERS Employer Rate Forecast for Placentia through 2050



Composite rate for all tiers; June 30, 2012 CalPERS Valuation Report for Placentia



4. Based on current payroll data, changes in the employer rate will drive Placentia's total retirement costs from \$2.7 million in FY 2012-13 to \$2.96 million in FY 2013-14. Costs will peak at more than \$3.8 million in FY 2017-18 before declining again. Approximately 98% of Placentia's retirement costs are paid by the City's general fund. Consequently, projected increases in retirement rates and associated costs will further exacerbate Placentia's structural budget deficit to the point of possible financial insolvency, absent significant changes in revenues and/or expenditures. As we reported in May, Placentia has relied on a series of one-time measures to balance its budget for the last five years. Those one-time measures are no longer available. The magnitude of the City's projected deficit given anticipated PERS expenses means that future fiscal viability will require significant increases in revenues, decreases in expenditures, or a combination of both.

### **Budget Stabilization Alternatives and Recommendations**

Management Partners used information provided from interviews, focus groups, peer agency benchmarking, and our knowledge of budget stabilization trends and best practices to analyze opportunities for Placentia to improve its financial condition. The alternatives are grouped into three categories: revenue enhancements, compensation changes, and alternative service delivery.

#### Revenue Enhancement Options

As we reported in May 2015, the opportunities for Placentia to generate new revenues are limited. Due to the severity of the City's financial condition, we focused our analysis on the enhancements that would generate the most significant revenues.

1. Placentia has some opportunity to increase property tax revenues resulting from residential development. However, the amount of potential revenue generation from known planned projects is relatively low. Placentia is a built out community with little growth potential. Consequently, property tax growth will come primarily in the form of the annual increase allowed by Proposition 13. Revenues associated with development also take time to realize. There are currently three residential projects planned for development: Golden Avenue, Schaner Ranch, and the Sonnenblick apartment project. Collectively they will result in 40 additional residential units and potentially 225 new apartment units. Together, the estimated property tax generation from these three projects after full completion is approximately \$117,300 per year. Assuming the developments conform to community standards, they will provide needed revenue, but will also increase demand for City services. The revenue generated may not be sufficient to cover the costs of such increased demand.

## Recommendation 1. Facilitate the development of planned residential projects to generate additional property tax revenues.

2. New hotel development would generate more transient occupancy tax (TOT) revenues than increasing the TOT rate. Placentia's current transient occupancy tax (TOT) rate is 10%, which



is near the low end of the market for Orange County. By comparison, Anaheim's TOT rate is 15%, Garden Grove's is 14.5%, and the TOT in Newport Beach is 9%. The City's adopted FY 2013-14 budget anticipates generating approximately \$650,000 per year in transient occupancy taxes from its three hotels. A 1% increase in Placentia's TOT will generate only \$6,500 per year.

Based on 2011 data, the three hotels generate an average TOT of approximately \$1,272 per room per year. Assuming a site and developer could be identified, the potential revenue from a new, 100-room hotel is approximately \$127,200, in addition to any increased property tax. Developing a new hotel property will generate more revenue than asking voters to approve an increase in the TOT rate. Like the increase in property tax resulting from new development, however, it will take time for the City to realize additional TOT revenues from a new hotel.

# Recommendation 2. Focus economic development efforts on the development of a new hotel property to generate additional transient occupancy tax revenue.

3. Placentia's 3.5% utility users' tax (UUT) is lower than rates for comparable peer agencies, and is lower today than when the tax was first instituted. By contrast, Stanton has a UUT rate of 5%, Azusa charges a 4% rate for residential and 8% for commercial users, and San Gabriel's rate is 8%. The UUT is applied to electric, natural gas, telephone, and cable bills. The UUT rate was originally established at 5% with the revenues intended to repay bonds issued for the construction of City Hall in 1973. Those bonds have since been repaid. According to staff, the City Council passed a resolution reducing the rate to 3.5% in the late 1990s. As a result of Proposition 218 and other case law, increasing the UUT now requires voter approval.

Actual UUT revenues were approximately \$2.86 million for FY 2012-13. A 1% increase in the rate would generate an additional \$800,000. Restoring the rate to 5% would generate approximately \$1.2 million in new revenue. Anecdotally, we learned that Placentia residents pay an average of \$15 to \$20 per month in utility users' taxes. Increasing the UUT to 5% would represent an increase of between \$.225 and \$.30 per month, or between \$2.70 and \$3.60 per household per year. If approved, it would eliminate most of Placentia's current \$1.5 million budget deficit.

### Recommendation 3. Ask voters to restore the utility users' tax rate to 5%.

4. The City's general fund is subsidizing existing landscaping and lighting districts by approximately \$415,000 per year. Landscaping Maintenance District 92-1 was formed in 1992 to finance the funding of park and median island landscaping and related maintenance in a small portion of the City. Street Lighting District 81-1 was formed in 1981 to finance street lights and associated costs in the same area as the landscaping maintenance district. The assessment amount for each of these districts has not been increased since inception, even though associated costs have significantly increased. Currently this results in a general fund

subsidy of \$170,900 for the landscaping district and \$245,180 for the street lighting district. This subsidy is anticipated to increase in the future unless the City takes steps to adjust the assessment amounts. Doing so will require the preparation of an Engineer's Report as a precursor to a Proposition 218 protest hearing process. Some communities have included pass-through or annual rate adjustments in the assessment for cost increases (such as for utilities) beyond their control. The Engineer's Reports would need to be prepared by March or April 2014 and the protest hearing be completed by July for the new assessment amounts to become effective with the 2014 property tax roll.

Recommendation 4. Prepare an Engineer's Report and conduct a protest hearing in compliance with Proposition 218 to increase the assessment for Landscape Maintenance District 92-1 to eliminate the current general fund subsidy. Include an automatic adjustment for inflationary increases in utilities and other costs beyond the City's control.

Recommendation 5. Prepare an Engineer's Report and conduct a protest hearing in compliance with Proposition 2018 to increase the assessment for Street Lighting District 81-1 to eliminate the current general fund subsidy. Include an automatic adjustment for inflationary increases in utilities and other costs beyond the City's control.

5. Placentia may be able to establish additional assessment districts similar to those that exist in the rest of the City. A review of assessment district alternatives was conducted by Harris and Associates in November 2011. The project report estimates potential revenues for four types of assessment districts. Table 1 shows the types of districts considered and the estimated revenue potential for each.

Table 1. Estimated Revenues for Various Citywide Assessment Districts

Assessment District Type	Estimated Annual Revenue		
Park Maintenance	\$911,400		
Street Trees and Sidewalks	\$875,000 \$2,050,000		
Fire Suppression			
Street Maintenance	\$500,000		

Source: Review of Assessment District Alternatives, report prepared by Harris and Associates, November 22, 2011.

Harris and Associates reported, "prior to the consideration of any assessment, further analysis and study would be needed to develop a detailed assessment methodology which is consistent with the requirement that any assessment must be proportional to the specific benefit received by a parcel, and that assessments can only be levied for 'special benefit'" (page 11). We concur with this finding. Such analysis would need to be completed by



March or April of 2014 and a protest hearing conducted by July 2014 to commence the assessments effective with the November 2014 tax roll.

Recommendation 6. Conduct additional analysis to determine the feasibility of establishing additional assessment districts and to develop a detailed assessment methodology consistent with the requirements of Proposition 2018.

6. Increasing the local sales tax by one-half cent would generate approximately \$1.9 million in new revenues for Placentia. Such local sales tax increases are uncommon but not unheard of in Orange County. For example, voters in La Habra passed a local half-cent sales tax in 2008 to replace \$5.5 million in reduced revenues when a utility users' tax expired. Statewide, nine out of 10 municipal general purpose add-on sales tax measures were approved by voters in November 2013. Several of these were in cities that had declared a fiscal emergency.

It is doubtful that the community would approve all of the revenue opportunities available to Placentia simultaneously. Policymakers will need to carefully consider the options, but should not dismiss revenue generation as a budget stabilization strategy, given the City's current and projected fiscal condition.

Table 2 summarizes the revenue enhancement options available to Placentia.

Table 2. Summary of Potential Revenue Enhancement Options and Estimated Financial Impacts

Re	venue Enhancement Options	Comments	Estimated Annual Revenues
1.	Complete the development of current residential projects in the pipeline (Golden Avenue, Schaner Ranch, Sonnenblick).	New property taxes	\$117,400
2.	Develop a new 100-room hotel.	Increased TOT	\$127,200
3.	Restore the UUT to 5%.	Requires voter approval, estimated increase per household of \$2.70 to \$3.60 per year	\$1.2 million
4.	Increase the assessment for Landscape Maintenance District 92-1 to eliminate the current general fund subsidy.	Requires Proposition 218 protest hearing; impact is increase of about \$67 per year per parcel (\$5.57 per month)	\$170,900
5.	Increase the assessment for Street Lighting District 81-1 to eliminate the current general fund subsidy.	Requires Proposition 218 protest hearing; impact is increase of about \$49.90 per parcel annually (\$4.16 per month)	\$245,200
6.	Establish additional assessment districts for the rest of the City.	Requires Engineer's Report to calculate costs and benefits; Proposition 218 protest hearing	TBD
7.	Increase local sales and use tax by one-half of a cent.	Requires voter approval at general election	\$1.9 million
	Total		\$3.7 million



#### Compensation Change Options

To its credit, Placentia has already negotiated a variety of concessions that have capped or reduced costs associated with employee compensation, including sharing the cost of retirement benefits with non-safety employees. Management Partners reviewed the most recent memorandums of understanding for each labor association and identified several options for changing compensation to further reduce costs. All of these would require the City to meet and confer with its labor associations in compliance with state law.

1. All employees except those in the Placentia Police Officers and Police Management Associations are paying the full employee share of retirement costs. Negotiating for safety employees to pay the employee share would bring parity to the organization and be consistent with the intent of PEPRA. However most other agencies have found it difficult to reach agreement on retirement cost-sharing with employees without offering commensurate salary increases or other incentives to offset the impact on salaries and wages. Negotiating retirement cost-sharing with police employees would save the City approximately \$257,000 annually. This amount would be reduced to the extent that offsetting salary increases were offered.

Recommendation 7. Negotiate for police employees to pay the employee share of retirement costs.

2. Costs associated with increases in health and dental premiums could be reduced by paying a percentage of health and dental premiums instead of a flat fee that rises with each premium increase. Instead of paying a flat fee for premiums, the City could negotiate to pay a percentage of benefits costs, with employees paying the balance. As premiums increase, both the City and employees would share in the additional cost. Management Partners estimates the financial impact of an 85/15% cost-sharing arrangement for health insurance premiums (i.e., the City pays 85% of premium costs and employees pay 15%) to be a savings of approximately \$230,000 per year. A 90/10% cost-sharing arrangement for dental benefits would save the City approximately \$10,900 per year.

Recommendation 8. Expand cost-sharing for health benefits by paying a percentage of premiums instead of a flat fee.

Recommendation 9. Expand cost-sharing for dental benefits by paying a percentage of premiums instead of a flat fee.

3. Costs associated with special or premium pays could be reduced by negotiating to change them from a percentage of salary to flat rates. Currently all special or premium pays are provided as a percentage of base salary. Examples of special pays include bilingual pay, education pay, longevity pay, shift differential pay, or premiums for special assignments. Because they are calculated as a percentage of salary, the cost increases every time an eligible employee receives a merit, promotion, or other salary increase. We estimate that changing to a flat



dollar amount would save the City approximately \$16,300 per year in the short term, but even greater savings in the future because costs would be capped.

## Recommendation 10. Negotiate to change all special pays to flat rates instead of a percentage of salary.

4. Currently Placentia labor agreements allow computation of eligibility for overtime to include both actual hours worked as well as paid leave, which exceeds the standards set by the Fair Labor Standards Act (FLSA). FLSA excludes all paid leave from overtime eligibility calculations. Public agencies, particularly those experiencing fiscal constraints, are negotiating with labor groups to follow the FLSA standard as a means for reducing expenditures. We estimate that following the FLSA standard for overtime calculation will reduce Placentia's costs by 20%, or approximately \$156,000 per year.

# Recommendation 11. Negotiate to follow the FLSA standard for calculating overtime eligibility.

Table 3 summarizes Placentia's options for changing compensation to improve budget stability.

Table 3. Summary of Potential Compensation Change Options and Potential Financial Impacts

	Compensation Change Options	Comments	Estimated Annual Savings
1.	Negotiate for police employees to pay the employee share of retirement costs.	Would result in equity for retirement cost sharing throughout the organization. Financial savings only achieved if commensurate salary increases are not approved.	\$257,000
2.	Expand cost sharing for health benefits by paying a percentage of premiums instead of a flat fee that rises with each premium increase.	Recommend an 85% cap on premium (employees pay 15%).	\$230,000
3.	Expand cost sharing for dental benefits by paying a percentage of premiums instead of a flat fee that rises with each premium increase.	Recommend a 90% cap on dental premiums (employees pay 10%).	\$10,900
4.	Change all special pays to flat rates instead of a percentage of salary.	Changing to a flat dollar amount increases future savings as costs will not increase with each future salary or step increase.	\$16,300
5.	Follow FLSA standard for calculating overtime eligibility.	Eligibility determined by actual time worked, not compensated leave time.	\$156,000
Total			\$670,200



#### Alternative Service Delivery Options

The term "alternative service delivery" refers to a variety of ways to provide public services. These include outsourcing or privatizing services, sharing services with other agencies under a regionalized service delivery system, or consolidating services with one or more agencies.

- Placentia is already utilizing alternative service delivery to provide many of its services. Examples
  include the current contract with the Orange County Fire Authority for fire and emergency
  medical response services, collaboration with The Friendly Center to provide recreation
  programming, and contracts with private vendors for street sweeping, refuse hauling,
  graffiti removal, and park and median island maintenance.
- 2. Costs for the Placentia Police Department represent 49% of the City's general fund budget, or \$14.9 million, including all overhead charges. As other programs and department allocations have been reduced, the percentage of the general fund supporting public safety, including police services, has increased. Like other departments, funding for the Police Department has been reduced in recent years. Steps taken to reduce costs include freezing vacant officer positions, reducing budget allocations to the Investigations and Support Services Divisions by 20% each, and increasing the use of part-time positions for certain non-sworn functions.
- 3. Despite ongoing expenditure reduction measures, costs for police services are expected to rise even higher over the next five years. This is due both to increases in PERS retirement rates, but also to a mandatory upgrade to the City's communications and dispatch system that will be required in 2017, costing between \$1 and \$2 million. Unless Placentia is able to increase revenues substantially, eliminating every other department, program or service might not be sufficient to close the resulting budget deficit in FY 2017-18. While the department is currently able to perform basic services, concern has been expressed that continued financial constraints will ultimately result in a degradation of service to the community, an inability to recruit and retain qualified personnel, and a less professional, effective organization.
- 4. Placentia has the potential to save significant costs while maintaining services levels through an alternative service delivery model for law enforcement services. Contracting for law enforcement services with another agency can be achieved more quickly than creating a new regional law enforcement agency. The option likely to have the greatest cost savings potential is to contract with the Orange County Sheriff's Department, particularly since the Sheriff is now serving Yorba Linda. However, other nearby cities such as Brea and Fullerton may be able to provide some savings through economies of scale.
- 5. Cost savings to contract with the Orange County Sheriff are estimated to be approximately \$4.3 million per year, although savings would be decreased in the initial year due to transition costs (such as cash outs for accrued leave). To calculate potential savings, Management Partners applied the cost formulas used by the Orange County Sheriff in its proposal to Yorba Linda to Placentia's current staffing and deployment. We estimated start-up and facilities

maintenance costs (assuming the Sheriff would want to use the City's existing police facility), and assumed a 6% rate adjustment in FY 2014-15 as per the Yorba Linda contract.

Based on our analysis contract costs are estimated to be approximately \$10.6 million annually. This equates to an annual cost savings of \$4.3 million based on current budget figures. In addition, initial savings would be reduced by approximately \$515,000, which reflects the current value of accrued leave (excluding sick leave) for Police Department employees. However, determining actual costs and potential savings requires obtaining an actual proposal from the Sheriff.

## Recommendation 12. Issue a request for proposals to determine the exact cost of contracting law enforcement services.

- 6. Contracting with the Sheriff will not relieve Placentia of its obligation to pay for accrued and unfunded liability for pension and retiree health benefit costs, but would cap those costs at the time the responsibility for providing services is transferred. We contacted CalPERS to learn what happens when employees are transferred to another agency, leaving a city with no active employees in the plan against which to charge rates for remaining unfunded liability. We were advised in such cases agencies having remaining unfunded liability are billed a dollar amount instead of a percentage of pay. Should Placentia decide to contract with another agency for police services, CalPERS would probably present it with the equivalent of a debt service schedule, with anticipated payments to be made over a fixed period of time. The exact terms would need to be negotiated with CalPERS based on actuarial valuation of the remaining liability as of the date of transfer.
- 7. There may be additional opportunities for cost savings through outsourcing. Although Placentia appears to have already contracted most of its park and landscape maintenance services, there may be additional opportunities worth exploring. It should be noted that contracting a service does not mean a city gives up control or management responsibility. Even if a service is delivered by a private contractor, at least some employees will still be required to provide strong oversight and contract management. Further analysis is required to determine whether there are additional alternative service delivery options for maintenance or other services.

### Recommendation 13. Explore options for additional contracting of maintenance or other services.

Table 4 summarizes the alternative service delivery options available to Placentia and their estimated fiscal impact.

Table 4. Summary of Alternative Service Delivery Options and Estimated Savings

A	Iternative Service Delivery Options	Comments	Estimated Annual Savings
1.	Issue a request for proposals to determine the exact cost of contracting law enforcement services	Estimated savings based on recent Orange County Sheriff proposal to Yorba Linda <sup>1</sup>	\$4.3 million
2.	Explore options for additional contracting of maintenance or other services.	Unclear whether there are opportunities to expand contracting of park and landscape maintenance	TBD
Tot	tal		\$4.3 million

<sup>&</sup>lt;sup>1</sup>Estimates assume existing patrol staffing levels due to limited workload information available. Includes start-up costs of \$500,000 spread over five years assuming credit for some equipment, and a 6% cost increase in FY 2015-16 similar to Yorba Linda's contract. Costs include all internal service costs not currently reflected in the Police Department operating budget. Annual savings does not include \$515,000 in first-year transitional costs for leave cash outs.

#### Conclusion

Placentia has experienced significant budget challenges since at least 2008 and has used a variety of strategies to bring expenditures in line with revenues. Unfortunately, one-time measures to balance the budget have been exhausted and staffing and service levels have already been reduced in order to bridge the gap. There are no easy options available. Given its current and projected fiscal condition, Placentia will need to find ways to significantly increase revenues and/or reduce costs to remain financially viable. Achieving long-term budget stabilization will take a concerted effort by the City Council and staff, in partnership with the Placentia community. The recommendations in this memorandum provide a pathway to begin the journey together.

